Trio of Disputes Set to Shape Burgeoning Tax Equity Insurance Biz

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A highly specialized but competitive market for insurance against risks inherent in renewable energy tax equity investments has emerged and blossomed over the past three years. And while three active tax disputes loom large, industry insiders expect the final rulings to bolster the niche industry, whichever way they fall.

The tax equity insurance industry, though young, already counts some dozen carriers among its ranks, including big names like **Zurich Insurance Group, American International Group** and **Chubb Limited**, which provide coverage to about 25 to 30 tax equity investors, most of whom are financial institutions.

While tax insurance has been around since the 1980s, when **Lloyd's of London** first covered investors against potential tax losses in lease transactions, and energy tax credits were first introduced in the U.S. in 1978, the concept of renewable energy tax equity is much newer.

A substantial increase in investment and production tax credits for solar and wind projects in 2006, combined with the growing popularity of renewables, contributed to a steadily growing market for tax equity, while the introduction of the Section 1603 cash grant program in 2009 ensured that the incentive remained in place throughout the financial crisis.

However, reliance on the tax code for the viability of an investment introduces an element of risk that neither financial investors nor project developers are particularly comfortable with—the risk of an unexpected, unfavorable tax ruling.

"The returns on tax equity investments are reasonable and decent and have limited upside, but you have to have a certain protection and that's where the insurance comes into play," says **Izzet Bensusan**, managing partner and founder of **Captona** and **Karbone**.

From the investor's point of view, since developers are usually already obliged to indemnify them for adverse events such as the disqualification of a project or recapture of a tax credit, the insurance product is as much about counterparty risk as tax risk, if not more.

"In many situations, the developers are going to be on the hook anyway for a tax indemnity, so the tax insurance is simply bringing a more creditworthy balance sheet to the table," explains **Gary**

Blitz, head of the tax insurance practice at insurance broker **Aon** and co-head of the firm's transaction solutions group.

Over the last three years, as demand for these insurance products has taken off, premiums have steadily fallen as insurers have become familiar with an array of complex tax-oriented structures including partnership flips, sale-leasebacks and inverted leases.

Triple threat

The budding insurance business could soon face disruption, however, depending on the outcomes of three court cases.

"The entire wind and solar markets are watching these cases with interest to see how they are decided," says **Keith Martin**, a partner at **Norton Rose** and the firm's co-head of projects based in Washington, D.C.

The best known of the three is the Alta Wind case, a dispute over the size of the cash grant for the massive wind project of the same name in California. The case grabbed headlines in July after the **U.S. Appeals Court for the Federal Circuit** sent it back to the U**.S. Court of Federal Claims** to be reheard under a different judge, eight years after the original financing (PFR, 8/16).

The case could redefine how appraisers determine a project's fair market value, limit the range of transactions that insurers are willing to underwrite, have ripple effects on premiums or influence the decisions of new players around whether to enter the market.

"The question is: 'Will insurance underwriters react to the cases going forward?' And the answer is: 'Of course,'" says Blitz.

Faced with transactions with a similar structure and fact pattern to Alta Wind, insurers may either rework the terms of the policy to bring it in line with the case and tax law or refuse to provide coverage at all.

Determining the eligible basis in tax equity transactions could also become trickier.

"Since the appeals court sent the Alta case back to the lower court in late July, the market may be less confident about which is the better way to step up asset basis—sell the project company or rely on a developer fee—but most deals closing this fall have been relying on project company sales," says Martin.

Developing situation

Another dispute involving the 1603 cash grant concerns **Invenergy**'s tax equity partnership with **U.S. Bank** for the Bishop Hill wind farm in Illinois. The Treasury doled out a smaller cash grant than the sponsor had applied for, citing a contentious $60 million "developer fee."

Invenergy is now seeking the roughly $12 million shortfall in damages, while the tax division of the U.S. **Department of Justice** claims, firstly, that the developer fee is an ineligible component of the cost basis for the facility and, also, that when the fee was paid, the developer and the tax equity partnership were not separate entities for tax purposes.

"Early skirmishing in the Bishop Hill case suggests that Invenergy will win on whether a developer fee can be added to the tax basis," opines Martin. "It is just an issue at this point of how much."

"Legal sham"

The third case has to do with a third-party tax equity investment rather than a cash grant and involves paint manufacturer **Sherwin-Williams**, which provided $7 million to finance assets for mobile solar company **DC Solar Solutions**.

The partnership in the case, Solar Eclipse Investment Fund III, was described as a "legal sham" by the **Internal Revenue Service**, which reduced the tax basis in the assets to zero after claiming the partnership inflated its asset prices (PFR, 9/20).

“More rigor”

The perception that the IRS is more aggressively auditing deals seems, if anything, to be a boon for the insurance business.

“At the start of the cash grant program, the Treasury paid everything sponsors requested,” says **David Burton**, a partner at **Mayer Brown** and the head of the firm’s renewable energy group in New York. “Then the Treasury started haircutting and people started being more conservative. You’ve seen more rigor around appraisals, preference for bigger balance sheet players able to back an indemnity, and more use of ITC insurance.”

In particular, there has been growing demand for insurance against a revaluation of a project’s tax basis, which tends to take the form of a seven-year policy paid up-front.

More tax equity insurance providers are expected to enter the market as the business grows, and Blitz reckons two or three more could enter next year.

“In an odd way, these cases are a positive thing as they give underwriters some clarity before they enter the market,” he says. “What the insurer seeks to achieve with the insurance product is to add certainty where the tax law has ambiguity.”

The rulings could also affect premiums, especially if insurers end up paying out. But a tax loss resulting from a court case does not guarantee an insurance payout, given the bespoke nature of the policies.

“What insurers do when they underwrite a transaction is set terms based on what is before them,” says Blitz. “There may be recourse against a sponsor, or credit-enhancing a sponsor’s obligation, and there also may be a deductible or limitations on the policy’s terms and conditions.”

However the cases are resolved, experts say the steady decline in premiums is likely to continue.

“As long as appraisals are done consistently with whatever adjustments the decisions ultimately require, I don’t think it will cause premiums to go up,” says **Richard Cogen**, a New York-based partner at **Nixon Peabody** and co-leader on the firm’s energy and infrastructure projects team. “Uncertainty causes bigger impacts on the market than having clear guidance and certainty.”

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